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The proposed Safe Banking Act of 1977, H.R. 9086 (95th Congress), is responsive to previous GAO recommendations of legislative changes that could be made to improve the efficiency and effectiveness of the Federal bank regulatory agencies' operations. The general thrust of the proposed legislation in the area of supervisory authority over financial institutions, which would include the authority to remove bank officers for gross negligence and to levy civil penalties for certain violations, could enhance the ability of supervisory agencies to deal with bank problems. Provisions in the proposed legislation for a hearing process for removal of an officer or director of a bank based on an indictment or conviction for a felony would correct the deficiencies in existing procedures and will allow the agencies use of this authority when appropriate. Providing the Federal Deposit Insurance Corporation with the power to approve or disapprove the establishment and operation of branches in foreign countries by State nonmember insured banks is consistent with existing law with respect to other banks. Provisions which would establish the framework for an effective mechanism for insuring interagency cooperation and coordination will help to avoid duplication of effort and afford equal treatment to all classes of banks. (SC)

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STATEMENT OF

ROBERT F. KELLER

DEPUTY COMPTROLLER GENERAL OF THE UNITED STATES

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

SUPERVISION, REGULATION AND INSURANCE

COMMITTEE ON BANKING, CURRENCY AND HOUSING

HOUSE OF REPRESENTATIVES

Mr. Chairman:

I am pleased to appear before this Subcommittee to discuss the proposed Safe Banking Act of 1977, H.R. 9086.

As a matter of background, in the spring of 1976 the General Accounting Office in response to requests from this Subcommittee and several other congressional committees undertook a study of the effectiveness of the Federal supervision of commercial banks. We issued a report to the Congress on

January 31, 1977, and an issue paper on the structure of Federal regulation of banks on April 14, 1977.

As your Subcommittee is well aware, our Office does not have specific legislative authority to audit the operations of the Federal Reserve System or the Comptroller of the Currency. Also, our access to the bank examination reports of the Federal Deposit Insurance Corporation has long been a matter of dispute. In light of the congressional interest, the agencies allowed us to make the study under certain conditions. One principal restriction was that GAO would not evaluate the accuracy of the examiner's factual findings by conducting separate examinations of the banks involved.

On February 1, 1977, the Comptroller General testified at joint hearings before this Subcommittee and a subcommittee of the House Government Operations Committee. During these hearings the Comptroller General discussed several areas where legislative changes may be needed to improve the efficiency and effectiveness of the Federal bank regulatory agencies' operations.

These areas included:

--Providing the Comptroller of the Currency flexibility to examine national banks at his or her discretion.

--Utilizing each other's examiners when conducting examinations in foreign countries.

--Establishing a mechanism for more effective coordination.

--Removing bank officers for gross negligence.

--Levying fines against banks, or against bank officers or directors, for violations of certain laws and regulations.

--Allowing the Comptroller of the Currency to present evidence and argument at removal proceedings conducted by the Federal Reserve.

The proposed legislation now being considered by your Committee is responsive to these recommendations. I will not repeat the arguments which the Comptroller General has already presented to your Committee for legislative changes but I would like to briefly discuss some of the principal provisions of the bill.

My comments are based primarily on our study of the bank regulatory agencies. Several of the areas included in the proposed legislation were not considered during our study. Consequently, we are not able to testify from a base of intensive research of some of the areas which the proposed legislation covers.

SUPERVISORY AUTHORITY OVER FINANCIAL INSTITUTIONS

Although our study concluded that in the past the supervisory agencies have not used their legal powers often enough, additional powers could enhance their ability to deal with bank problems. The authority to remove bank officers for gross negligence and to levy civil penalties for certain violations could be useful. Therefore, we support the general thrust of the proposed legislation in this area.

Civil Penalties

One basic observation in our study was that individuals cause bank problems, but available legal powers are not aimed at deterring actions by individuals. Therefore, we favor granting authority to levy civil penalties against bank officials who violate certain laws, regulations and appropriate orders.

Sections 101, 102, 103, 106, and 107 provide for the assessment of civil money penalties for violations of

--insider loan and loan to affiliate sections of the Federal Reserve Act,

--reserve requirement provisions of the Federal Reserve Act,

--the National Bank Act, and

--the terms of appropriate orders issued by the supervisory agencies.

The supervisory agencies requested authority to assess civil money penalties for some of these same violations in a similar bill (S. 2304) which was considered in the second session of the 94th Congress. A bill (S. 71) identical to S. 2304 was introduced in the first session of the 95th Congress.

In our report to the Congress in January, we noted that while relatively few banks in our samples were cited for violating laws and regulations relating to insider loans and loans to affiliates, the authority to levy civil penalties could be an effective deterrent. We believe that such authority would enhance the supervisory agencies' ability to deal with bank problems.

One problem which the Committee might want to consider is that the proposed legislation provides only a penalty for continuing the violations referred to in these sections. The language of the bill implies that an assessment of a civil penalty may only be made when a continuing violation is identified by the agency. For example, if a loan was made in violation of a law or regulation in February, paid off in July and discovered by the examiner in August, it is questionable whether a penalty could be assessed.

Also, depending on the interpretation, the penalty would be assessed from date of violation or from date of discovery or from written notice by the bank examiner. The deterrent could be more effective by establishing a civil penalty for committing the violation in addition to the penalty for each day the violation continues.

Additionally, the assessments to be made under title I are to be "by written notice." We feel that the written notice should contain a statement of the facts constituting the alleged violation or violations, and also should state that the recipient has the right to an agency hearing, and specify the time within which the request for hearing must be made. This, it seems to us, would enhance the due process character of the actions, and would conform to the analagous provisions of the Financial Institutions Supervisory Act of 1966 (12 U.S.C. § 1818), and the provisions of Section 106 of the bill, which amends that Act.

We also note that agency final orders are subject to judicial review in the Federal circuit courts. However, these provisions of title I state that "The findings *** shall be set aside if found to be unsupported by substantial evidence as provided by section 706(2)(E) of title 5, United States

Code." The reference is to a section of the Administrative Procedure Act, or "APA." The "substantial evidence" test is only one basis, under the APA, upon which the reviewing court may set aside an agency action. Among the other tests set out in the APA are whether the agency action is arbitrary, capricious, an abuse of discretion, or in excess of constitutional or statutory authority.

It would appear from the language in title I of the bill that the scope of judicial review is intended to be considerably narrower than that ordinarily afforded under the APA. We are unable to discern any reason for that limitation. It seems to us that the protections afforded by the APA should apply to these agency actions, particularly in view of the fact that the question of whether or not a violation occurred may often present a question of law rather than fact.

We believe, therefore, that the Committee should consider using, instead, language similar to that employed in the Financial Institutions Supervisory Act of 1966. For example, the sections could be changed to read "Review of such proceedings shall be had as provided in chapter 7 of title 5, United States Code."

If, on the other hand, the language employed in the bill is intended to preclude a de novo judicial hearing of the facts, we believe the language should be clarified to specify that, while not otherwise limiting the application of the APA.

The Committee may also want to make some provision for violations of consumer protection laws since they are not included in these sections.

Loans to Insiders

One bank problem--insider loans--is of particular concern because it is commonly found in banks that failed. An insider loan may be described as direct or indirect credit to a bank officer, director, major shareholder, or his interests. These loans are not necessarily improper or detrimental to a bank, but they may be if abused. The loan should be properly secured with collateral and have the same interest rates as those offered to other borrowers.

Sections 104 and 107 of the bill would cut back on the amount of loans that a bank can make to its officers, directors, or major stockholders or to the business firms they control. During our study of the bank regulatory agencies, we noted that insider loans, while not one of the more prevalent problems cited by bank examiners, did cause severe problems in some banks. For example, our examination of agency records of 30 banks that failed during a 5-year period prior to our study, revealed that 14 of the banks failed because bank management made improper or self-serving loans to insiders.

The problem that we found during our study of the banking agencies was not that excessive insider loans were not being identified and criticized by bank examiners, but rather that the agency did not take aggressive actions to correct the problems identified. We should point out, however, that our study was primarily limited to reports and records at the Federal agencies and that we did not examine banks to determine whether additional insider loan problems existed which were not being detected by the bank examiners.

Based on our discussions with agency officials about the environment that may exist at some banks, we question the provisions of subsection (h)(2) of section 104 of this bill. The subsection would permit member banks to make loans or extensions of credit in excess of $25,000 to its own officers, directors, or persons who own or control the management of the bank or their interests if two-thirds of the board of directors approves the loans or extensions of credit with the interested party abstaining from participating directly or indirectly in the voting.

In certain banks the individuals covered by this provision of the bill by virtue of their position may so dominate the board of directors that approval would be virtually automatic without their obvious intervention in any fashion, yet supervisory agencies would have difficulty showing that the interested party had directly or indirectly influenced the voting.

<u>Financial Assistance to Acquire Assets of Failing Savings and Loans</u>

Section 105 provides the Federal Savings and Loan Insurance Corporation (FSLIC) with the authority to make loans to a savings and loan association that is buying the assets of a failing savings and loan association. This authority is similar to that in existing legislation for the Federal Deposit Insurance Corporation for use in its supervision of commercial banks. We see no objection to granting this authority to the FSLIC.

<u>Cease and Desist/ Removal Actions</u>

Section 106 of title I would give financial regulatory agencies the authority for cease and desist actions against officers, directors, or any person participating in the affairs of a financial institution for violations of laws and regulations, unsafe and unsound practices, or for any criticized action which would weaken an institution. It also provides for removal of officers and directors for breach of fiduciary duty, such as personal dishonesty, gross negligence, or continuing disregard for the safety of the institution.

In our January 1977 report we said that short of closing a bank or canceling its insurance, the formal powers that could be used to influence a bank were removing officers and issuing cease and desist orders. At that time, the agencies told us that removing bank officers is too cumbersome a procedure to be useful because they have to prove that the officers have committed acts of personal dishonesty which is difficult to do.

The agency officials said also that cease and desist orders are not always a deterrent to bank mismanagement, since they only require a bank to stop performing an act or to take affirmative action to correct the conditions resulting from any such violation or practice and provide no punishment for committing the act in the first place. We believe this is further support for establishing a fine for committing the act in addition to a penalty for each day the violation continues.

Another problem which the agencies pointed out was that available legal measures are not designed to sanction the individuals causing bank problems because the measures are aimed at banks--not bank officials--except for the unwieldy removal procedure.

We believe the proposed legislation addresses these problems.

HEARING PROCESS

Section 109 of the act provides for a hearing process for removal of an officer or director based on an indictment or conviction for a felony. In our report we noted that 12 U.S.C. 1818(g)(1) gives the agencies the authority to suspend any bank director or officer indicted for a felony involving dishonesty or breach of trust. The suspension is enforceable by written notice and remains in effect until the charges are disposed of or until the suspension is terminated by the agency. We pointed out that the statute has been declared "constitutionally infirm" by a three-judge federal court because it permitted the issuance of a notice and order of suspension without affording the individual an immediate post-suspension hearing, preceded by notice of such a right, and an opportunity to be represented by counsel, to make written submissions, and to make oral arguments.

We believe that the new provisions will correct the deficiencies found by the court and allow the agencies use of this authority when appropriate.

Along these same lines, 12 U.S.C. 1818(c) gives FDIC and FRS authority to order the removal of a director of officer of a State bank which they supervise while OCC must recommend that FRS remove one from a national bank. In our January report we said we would support legislation to allow OCC to present evidence and argument at removal proceedings conducted by the FRS. The Committee may wish to consider adding such a provision in the proposed legislation.

INTERLOCKING DIRECTORS

Title II prohibits certain outside activities by "management officials" of insured banks: specifically, acting as management officials of nonaffiliated depository institutions in the same area, insurance companies, and companies closely involved in real estate transactions (title companies, appraisal companies, etc.).

The law currently restricts certain outside activities of directors, officers and employees especially with regard to their involvement with nonaffiliated banks in the same area. This title adds additional restrictions.

We did not find interlocking directorates or management to be a frequently cited problem for those banks included in our samples. The examiners cited only one percent of the State member banks and national banks in our general sample for violating existing law with regard to interlocking directorates. Three percent of the "problem" State member banks were cited for such violations.

We are not able to say whether this title, had it been the law when the examinations we reviewed were conducted, would have resulted in any higher number of citations.

FOREIGN BRANCHING

Although entitled "Foreign Branching", Title III makes several changes to existing supervisory agency powers, with regard to all aspects of banking. For example, it expands the agencies' powers to administer oaths and affirmations. It changes the number of directors required to attest to the correctness of reports of condition.

Section 301 deals with foreign branching. Its effect is to give the Federal Deposit Insurance Corporation the power to approve or disapprove the establishment and operation of branches in foreign countries by State nonmember insured banks. The Federal Reserve has such authority with regard to national and State member banks.

Foreign branches now account for most of the international assets of domestic banks even though only one percent of the nation's banks operated such branches. Also, international operations are a major source of income for some banks.

Our study did not concentrate on the agencies' approval or disapproval of banks' applications for new branches (domestic or foreign) except when the action on applications was used as a supervisory tool to obtain corrective action on problems disclosed by examinations. However, we believe that the supervisory agencies should be overseeing the branching activities of the banks they supervise. This is especially important with regard to foreign branches.

Problems with foreign operations can lead a bank into severe difficulty, and perhaps even contribute to the bank's failure. Thus, we believe that having the FDIC oversee the establishment of foreign branches by State nonmember insured banks is consistent with existing law with respect to other banks and serves the interests of the FDIC as the insurer, the public, and the banks themselves.

CONFLICTS OF INTEREST

Title IV states that members of the Federal Reserve Board, the Federal Deposit Insurance Corporation Board of Directors, and the Federal Home Loan Bank Board cannot, for two years after leaving their positions, serve or own stock in a financial institution or a financial institution holding company. The Comptroller of the Currency is by law a member of the FDIC Board of Directors.

Our study of the personnel practices of the three agencies did not include a review of the subsequent employment of these officials, therefore we have no specific information to offer that would aid the Committee in passing on the merits of this provision.

There is nothing currently in law or in proposed legislation that is as restrictive on post service employment as title IV. Many of the individuals who serve in these positions come from the banking industry. They serve for several years--up to 14 years for Federal Reserve Board members--working in the specialized area of banking. Because this provision would place a severe limitation on the future employment opportunities available to these officials it might discourage qualified persons from accepting appointments to these positions.

CREDIT UNION RESTRUCTURING

Title V provides for the creation of a three member National Credit Union Administration Board. We have no information on the merits of a three member board. The three bank supervisory agencies each have a different management structure. The Office of the Comptroller of the Currency is managed by a single person; the FDIC is managed by a three-member Board of Directors; and the seven-member Federal Reserve Board directs the activities of the Federal Reserve System. We found no significant differences in the effectiveness of these agencies due to the management structure.

Section 102(g) provides authority to the GAO to audit the financial transactions of the Administration. We believe limiting this authority to financial transactions would be restrictive and could prevent us from performing reviews of program activities of the Board and Administration that could be helpful to the Congress in carrying out its legislative and oversight responsibilities. We suggest the language be revised to provide authority to audit program operations as well as financial transactions and also provide unrestricted access to all records and files of the Board and Administration including examination reports and related correspondence.

CHANGE IN BANK CONTROL ACT

Title VI gives FDIC the authority to approve or deny in advance any change in control of an insured bank. Our study did not specifically consider changes in control of a bank. However, changes in control could result in changes in management, and our study report did comment, in several places, on the problems the agencies had with bank managers. Management effectiveness was criticized at 16 percent of our sample of problem banks. In our study of 30 failed banks we found that the practices followed by the banks' managers were the primary cause of failure and that there was a lack of oversight and responsiveness by the banks' board of directors. Allowing FDIC to act on changes in control could give them an opportunity to evaluate a bank's plans to change management.

These views could also be applied to the authority being proposed for the Federal Home Loan Bank Board in Title VII.

EXTENSIONS OF CREDIT AND CORRESPONDENT BALANCES

Title VIII prohibits, without exception, extensions of credit by either bank in a correspondent relationship to the other's officers or directors or to persons controlling 5 percent or more of the other's stock. Such loans are not now specifically prohibited.

Not all loans from banks to the officers, directors or stockholders of their correspondent banks represent a misuse of the banks' funds. There is potential for abuse in such situations. We do not know if the present situation is of such magnitude to warrant legislation in this area.

DISCLOSURE

While we recognize that fuller disclosure of banking data has the benefit of bringing to bear certain disciplines from the public and the financial community that may not now exist, we believe that the Committee should carefully weigh not only the benefits but also the problems that such a disclosure could cause. For example, the provision requiring publication of the dollar amount of extensions of credit to director and stockholders together with other restrictions in this bill on directors and stockholders could discourage some qualified individual from investing or participating in the management of commercial banks.

With respect to the requirement that banks publish the dollar amount of loans classified substandard, doubtful, and loss at the last examination of the bank, we question whether the public--on the basis of this data--could properly assess the condition of their bank. The amount of such loans are only one of many indicators of the soundness of banks. The public could misinterpret the data and terminate their business relationship with a bank when, in fact, the bank was not in financial difficulty.

ESTABLISHMENT OF THE FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

To promote uniformity and consistency in the way that the three Federal bank regulatory agencies supervise their banks, section 1001 through 1009 of Title X of the bill provides for the establishment of a Financial Institutions Examination Council.

Effective cooperation between the three Federal bank regulatory agencies is important to:

--avoid duplication of effort,

--afford equal treatment to all classes of banks, and

--maximize economy and efficiency of operations.

We found that some coordination occurs between the agencies through formal and informal means. The current framework for coordinating the activities of the three regulatory agencies provides a forum for exchanging information about possible conflicting rules, regulations, or policies, but it does not provide a mechanism for the three agencies to combine their forces in improving the bank supervisory process or in resolving problems common to the three agencies.

An interagency coordinating committee was established at President Johnson's request in 1965 to resolve conflicting rules, regulations, and policies. It includes representatives of each of these three agencies, as well as a representative of the Federal Home Loan Bank Board.

The coordinating committee provides a forum for exchanging information about possible conflicting rules, regulation, or policies which might exist between the agencies. However, it does not provide a mechanism for the three agencies to combine their forces in undertaking significant new initiatives to improve the bank supervisory process or in resolving problems common to the three agencies. In our report we identified several areas where the agencies could benefit by working together, sharing experiences about innovations in bank supervision, and undertaking activities jointly or on a reciprocal basis.

As one possible solution to this problem, our report recommends that the Congress enact legislation to establish a mechanism for more effective coordination among the Federal agencies. As the Comptroller General testified last February, we would like to see legislation which would build upon S. 3494, a bill introduced by Senator Stevenson which would establish a Federal bank examination council.

The Comptroller General testified that he would like to see the membership of the council broadened to include at least the Federal Home Loan Bank Board and representation by either the State supervisory agencies or the public. He also would like to see the council have its own statutory status, its own funding, its own staff direct and have the Congress specify the kinds of things that the council would deal with.

As an adjunct to our study, we published an issue paper on April 14, 1977, on the debate on the structure of Federal regulation of banks. Chapter 4 of that document contains our observations on the Federal Bank Examination Council concept. You may wish to include it in this hearing record.

The provisions of this bill include the principal suggestions which we made and it establishes the framework for an effective mechanism for insuring interagency cooperation and coordination.

RIGHT TO FINANCIAL PRIVACY

Title XI provides restrictions on access to the financial records of customers held by depository institutions. Our study did not include such matters but we believe that the provisions of this title would help protect individual privacy.

With reference to the section dealing with Electronic Funds Transfer, we understand the Commission established by the Congress to study this problem will make its report shortly and therefore its recommendations will be available for consideration by your Committee.

In view of the provisions of H.R. 2176--the "Federal Banking Agency Audit Act"--and GAO's existing audit and access authorities at the Federal Home Loan Bank Board and the Federal Deposit Insurance Corporation, we feel that the Committee might want to clarify title XI with regard to GAO's access to examination reports and other agency records which might contain financial information about individuals.

CHARTERS FOR THRIFT INSTITUTIONS

Title XII provides authority to issue Federal charters to mutual savings banks. We have no information on the overall merits of this provision.

Section 26 provides that the GAO prescribe the meaning of the term "loss incurred by it which arises out of losses incurred by the converting bank prior to conversion" if the FDIC and the FSLIC cannot mutually agree upon the meaning of the terms. Rather than leaving this to interpretation by GAO we would prefer that the law be clarified to define what is intended t the terms or to provide more guidance so that the FDIC and FSLIC can reach agreement.

BANK HOLDING COMPANIES

Title XIII contains some sweeping changes to the relationship between the Federal Reserve (the primary Federal supervisor of bank holding companies) and bank holding companies. It also makes similar changes in the relationship of the Federal Savings and Loan Insurance Corporation vis-a-vis savings and loan holding companies.

In accordance with the terms of our agreement with the Federal Reserve, we did not conduct a comprehensive review of the supervision of bank holding companies. Rather, we confined our evaluation of holding company supervision to Federal Reserve actions with regard to holding companies affiliated with banks in our samples. Based on those cases, we concluded that

> "***the FRS holding company surveillance by financial analysis and limited onsite inspection did not discover problems in the holding companies or their nonbanking subsidiaries before those problems affected the affiliated banks. FRS should be attempting to identify and correct holding company problems before banks are affected. And we believe that more frequent indepth inspections of holding companies would enable FRS to do so."

Thus, we were concerned with improved supervision of holding companies rather than with new or strengthened rules and regulations. However, we believe that the provisions of title XIII are worthwhile improvements and will help the Federal Reserve supervise holding companies.

The authority given to the Federal Reserve by section 1301(a) to order bank holding companies to terminate activities or to terminate ownership of nonbanking subsidiaries which threaten the soundness of subsidiary banks should be an invaluable aid to the Federal Reserve's efforts. The provisions of section 1311 addressing adequate capitalization and financing of holding companies and their subsidiaries, the elimination of loan favoritism between banks and their holding companies and affiliates, and the regular reporting of intercompany loans should help curb actions which have, in the past, caused serious problems for some of the banks affiliated with holding companies.

One major concern of our review was the need for increased cooperation and coordination among the supervisory agencies. Thus, we suggest that section 1305 be modified to require the Federal Reserve to notify the Federal Deposit Insurance

Corporation as well as the Comptroller of the Currency and/or the appropriate State authority when it receives an application for approval under section 3(b) of the Bank Holding Company Act of 1956 as amended.

That concludes my statement, Mr. Chairman. We would be glad to answer any questions you may have.